PREME COURT

FILED
AUG 11 1969
CLERK

IN THE

Supreme Court of The United States

OCTOBER TERM, 1969

No. 341

MERRILL LYNCH, PIERCE, FENNER & SMITH, INC.

Petitioner,

vs.

DONALD W. BUTTREY, TRUSTEE IN BANKRUPTCY FOR DOBICH SECURITIES CORPORATION,

Respondent.

ON PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT.

BRIEF FOR RESPONDENT IN OPPOSITION

HUGH A. THORNBURG
822 Circle Tower
Indianapolis, Indiana 46204

ALAN I. KLINEMAN
JAMES M. KLINEMAN
1122 Circle Tower
Indianapolis, Indiana 46204

FRANK M. MCHALE
JOHN I. BRADSHAW, JR.
Chamber of Commerce Building
Indianapolis, Indiana 46204

Attorneys for Respondent.

KLINEMAN, ROSE AND WOLF
1122 Circle Tower
Indianapolis, Indiana 46204

MCHALE, COOK & WELCH
Chamber of Commerce Building
Indianapolis, Indiana 46204

Of Counsel.

Central Publishing Company, Inc., Indianapolis, Ind.

INDEX

	Page
Opinions Below	1
Jurisdiction	1
Questions Presented For Review	2
Statutes Rules and Regulations Involved	2
Statement of The Case	2
Argument	9
Reasons For Denying The Writ With Respect To Both Questions	9
Reasons For Denying The Writ With Respect To The First Question	10
A. There Is No Important Question Of Federal Law	10
B. There Is No Conflict Of Decision	11
C. The Decision Is Clearly Correct	15
Reasons For Denying The Writ As To The Second Question	16
A. The Decision Below Is In Accord With Decisions Of This Court	16
B. There Is No Conflict Of Decision With Other Courts	18

TABLE OF AUTHORITIES

Decisions

Page

American Construction Co. v. Jacksonville Rwy., 148 U.S. 372 (1893) 9

Barnes v. Schatzkin, 212 N.Y.S. 536 (1925); aff. 242 N.Y. 552, 152 N.E. 424; cert. den. 273 U.S. 709 (1926) 11, 12, 13

Colonial Realty Corp. v. Bache & Co., 385 F. 2d 178 (2d Cir. 1966) cert. den. 385 U.S. 817 .....18, 19, 20

Comm'r of Internal Revenue v. Est. of Herman J. Bosch, 387 U.S. 456 (1967) 12

Hamilton Shoe Co. v. Wolf Bros., 240 U.S. 251 (1916) .. 9

Howell v. Citizens First National Bank of Ridgewood, 385 F. 2d 528 (3rd Cir. 1967) 12

J. I. Case Company v. Borak, 377 U.S. 426, 84 S. Ct. 1555, 12 L.Ed. 2d 423 (1964) 17, 18

Market Street Railway Co. v. R. R. Commission of California, 324 U.S. 548 (1945) 9

Pettit v. American Stock Exchange, 217 F. Supp. 21 (C.D. N.Y. 1963) 15

Schneider v. O'Neal, 243 F. 2d 914, 918 (8 Cir. 1957) .. 14

Securities and Exchange Commission v. Kelly, CCH Fed. Sec. L. Rep. ¶ 90, 497 (N.D. Ill. 1951) 13

Silver v. New York Stock Exchange, 373 U.S. 341, 355, 83 S. Ct. 1246, 1255, 10 L.Ed. 2d 389, 398 (1963) ..16, 17

Tchlenoff v. Jacobs, 44 N.Y.S. 2d, 38, 39 (Sup. Ct. 1943), aff. 267 App. Div. 908, 46 N.Y.S. 2d 875, affd., 293 N.Y. 904, 60 N.E. 2d 32 (1944) 11

TABLE OF AUTHORITIES—Continued

Page

Other Authorities

4 Collier on Bankruptcy (14th ed.) 1038, 1534 14

Lowenfels, Implied Liabilities Based Upon Stock Exchange Rules, 66 Columbia L. Rev. 12 (1966) 20

Statutes

Bankruptcy Act

Section 70(c) [11 U.S.C. § 110(c)] 12

Section 70(e) [11 U.S.C. § 110(e)] 12

Section 60(e) [11 U.S.C. §96(e)] 13

Securities Act of 1933 (15 U.S.C. §77(a) et seq.)

Section 17 (15 U.S.C. 77q) 9

Securities Act of 1934 [15 U.S.C. 78(a) et seq.]

Section 14(a) [15 U.S.C. §78n(a)] 18

Section 6 [15 U.S.C. §78(f)] 16

Section 10 [15 U.S.C. 78(j)] 3

Regulations of the Securities Exchange Commission

Rule 10(b) 5 ..... 9, 13

Amendments to Bankruptcy Act

Chandler Act, Ch. 575, 52 Stat. 840 (1938) 11, 12

1950 Amendment, Public Law 461, 81st. Cong. (Chap. 70, 2d Sess.), Approved March 18, 1960 .. 12

1952 Amendment, Act July 7, 1952 12

Stock Exchange Rules

New York Stock Exchange Rule 405 ..... 3, 17

IN THE

Supreme Court of The United States

OCTOBER TERM, 1969

No. 341

MERRILL LYNCH, PIERCE, FENNER & SMITH, INC.

Petitioner,

vs.

DONALD W. BUTTREY, TRUSTEE IN BANKRUPTCY FOR DOBICH SECURITIES CORPORATION,

Respondent.

ON PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT.

BRIEF FOR RESPONDENT IN OPPOSITION

OPINIONS BELOW

The opinion for the Court of Appeals for the Seventh Circuit is reported at 410 F2d 135. The orders of the District Court overruling the Motion for Summary Judgment were unreported.

JURISDICTION

The jurisdictional requisites are adequately set forth in the Petition.

QUESTIONS PRESENTED FOR REVIEW

1. Whether under the provisions of the Bankruptcy Act and the Federal Securities Laws, a trustee in bankruptcy for a stockbroker can assert a right of action to avoid transfers from the bankrupt to a member firm of the New York Stock Exchange when the member firm knew that the property transferred had been unlawfully converted and used to purchase securities for the bankrupt's account.

2. Whether federal civil liability arises under the Securities Exchange Act of 1934 by reason of alleged violation by a New York Stock Exchange member firm of Rule 405 of the New York Stock Exchange, which provides in pertinent part that every member organization of the Exchange is required through a general partner or officer holding voting stock to:

> (a) Use due diligence to learn the essential facts relative to every customer, every order, and every cash and margin account accepted by such organization; and
>
> (b) Supervise diligently all accounts handled by registered representatives of the organization.

STATUTES, RULES AND REGULATIONS INVOLVED

The pertinent statutes, rules and regulations involved are stated in the Petition at pp. 3 and 4.

STATEMENT OF THE CASE

The Respondent herein, the Trustee in Bankruptcy for an Indiana corporation engaged in business as a securities dealer licensed by the state of Indiana, brings this action

to avoid transfers made from the Bankrupt to the Petitioner which transfers were in violation of the Federal Securities Laws and are therefore voidable by the Trustee in Bankruptcy under the pertinent provisions of the Bankruptcy Act.

Count I alleges that in its dealings with the Bankrupt, the Petitioner, a member of the New York Stock Exchange, violated Rule 405, the "Know Your Customer Rule" or "The Rule of Due Diligence" of the New York Stock Exchange, which Rule was adopted pursuant to Section 6 of the Securities Exchange Act of 1934 (15 U.S.C. § 78f).

Counts II and III are based on the same factual allegations. Count II alleges that the natural result of the "course of business" engaged in by the Petitioner operated as a fraud or deceit upon the Bankrupt in violation of Section 17 of the Securities Act of 1933 (15 U.S.C. § 77q) and Rule 10(b)(5) of the Securities Exchange Commission promulgated under Section 10 of the Securities and Exchange Act of 1934 (15 U.S.C. §78j). In Count III Petitioner is alleged to have "aided and abetted," Michael Dobich in violation of the same Sections of the Securities Laws as alleged in Count II.

The denial of the Petitioner's Motion for Summary Judgment as to each of these Counts was the basis for Petitioners Appeal to the Court of Appeals below.

The basic facts as alleged in the Complaint, and as contained in the record which was considered for purposes of Petitioners Motion for Summary Judgment are as follows:

The Bankrupt, Dobich Securities Corporation was incorporated October 23, 1963. Michael Dobich was President, one of only three members of the Board of Directors, the sole stockholder, and the completely dominant person of

the corporation. Prior to the formation of Dobich Securities Corporation, Michael Dobich had individually and in his capacity as the sole owner of the proprietorship known as Dobich Securities Company been licensed to sell securities to the citizens of the State of Indiana. Michael Dobich likewise had in his individual capacity and as the sole proprietor of Dobich Securities Company maintained accounts with Merrill Lynch at their Indianapolis office. Defendant knew that Michael Dobich as a licensed broker-dealer was obtaining funds and properties of citizens of the State of Indiana in payment of their purchases of securities through the Dobich Securities Company, and subsequently after its incorporation, through the Dobich Securities Corporation.

In its dealings with Michael Dobich prior to incorporation, Merrill Lynch had received several checks from Dobich in the years 1962 and 1963 which had been returned by Dobich's bank marked insufficient funds. In addition in 1963, Michael Dobich had maintained a commodity account with Merrill Lynch, which account had been placed on a limitation as to the volume of trading due to Dobich's "erratic trading" and also due to the fact that Dobich had refused to furnish a financial statement to Merrill Lynch.

From the inception of the Corporation, Dobich set out to delay delivery of the stock being sold to citizens of the State of Indiana. The delay was in order to allow the Corporation to use its customers' property for speculation. Numerous excuses and false statements were used to pacify and lull customers complaining about delivery delays.

On December 3, 1963, Michael Dobich requested Merrill Lynch to open a cash account in the name of Dobich Securities Corporation. The new account card, Merrill Lynch's form No. 21-R, which required that certain information be

supplied in compliance with Rule 405 of the New York Stock Exchange as supplemented by the New York Stock Exchange Guide, was not fully completed. No bank or broker reference was given. In addition no estimate of net worth was given. No financial statement was received by Merrill Lynch and no independent bank check or credit reference check was made by Merrill Lynch, except that the home office new accounts department requested a Dun & Bradstreet report on the corporation.

The Dun & Bradstreet report was received by the home office and examined by the new accounts department only as to whether or not the corporation was properly organized and whether or not Michael Dobich, who had been designated by the Corporation as President was in fact such an officer. The Dun & Bradstreet report indicated that all financial information had been declined by Dobich Securities Corporation. In addition it indicated that the proprietorship as of March, 1962 had an estimated net worth of only Twenty-eight Thousand Dollars ($28,000.00). Had an independent investigation of the Corporation's standing been made during the month of December, 1963, Merrill Lynch would have found that the Corporation account in a local bank was in an over-draft position for most of the month of December, 1963. In addition had Merrill Lynch required and obtained a current financial statement from the Corporation it would have ascertained that as of December 31, 1963 Dobich Securities Corporation was insolvent. The state of insolvency continued throughout the life of the Corporation.

Initially, the transactions in the cash account at Merrill Lynch consisted of deposits of stock and monies. All of the deposits in the trading account during the month of January, 1964 consisted of stock in the names of Dobich cus-

tomers endorsed in blank and Forty-eight (48) checks in a face amount of approximately $143,000.00 from Dobich customers made payable to Dobich Securities Corporation. The checks of third parties in some instances, were earmarked on the face of said checks for the purchase of specific securities. All of said checks were endorsed by Dobich Securities Corporation by Michael Dobich and then deposited by Merrill Lynch to the credit of the Corporation for its unrestricted use.

After several large transactions in the corporate securities account, in early February, 1964, Dobich requested that the corporate account be allowed to trade in commodities. This request was refused by the Commodity Credit Division of Merrill Lynch in New York since no current financial information had been made available on the Corporation to support the proposed large dollar amounts of trades in commodities.

Immediately thereafter, the original cash account of Dobich Securities Corporation was converted to a margin account. Although the purchase of securities on margin involved an extension of credit by Merrill Lynch no additional information, *i.e.*, bank references or financial statements was obtained from Dobich Securities Corporation by Merrill Lynch. Financial statements were requested of Mr. Dobich but this information was never furnished. During the months of February, March, April and early May, 1964, numerous transactions occurred in the corporation's margin account, including several individual transactions in the range of $300,000.00 to $450,000.00 each.

On May 14, 1964, the trading activity of the Dobich account came to the attention of the New York office of Merrill Lynch and an investigation was commenced by the home office staff with "particular emphasis on his financial stability." While the investigation was underway,

additional individual transactions up to $400,000.00 each were consummated in the corporate account.

During the week of June 19, 1964, as a result of the investigation conducted by the New York Office of Merrill Lynch, it was ordered that the Dobich Securities Corporation accounts together with the individual accounts of Michael Dobich be placed on a liquidation only basis and thereafter no new transactions were allowed with the exception of certain "cash purchases" during the latter part of 1964 and early 1965.

The net result of the transactions between the Bankrupt and the Petitioner, as broker, was the loss to the Bankrupt of approximately $465,500. Claims in excess of $2,500,000 have been filed with the Respondent on behalf of customers of the Bankrupt who gave the Bankrupt property for the purchase of stock which was never received by the customer.

The Petitioner, for the purpose of its Motion for Summary Judgment admitted that at all times alleged in the Complaint it knew the following:

a. Dobich Securities Corporation was entering into agreements to sell securities to the citizens of the State of Indiana and was obtaining funds or property from said persons in payment of such purchases.

b. Michael Dobich was the sole shareholder and principal officer of Dobich Securities Corporation.

c. Michael Dobich was financially unstable and had the propensity to speculate with large sums of money in the purchase of securities and commodities.

d. Michael Dobich in his individual account with Merrill Lynch had issued to Merrill Lynch three (3) checks in substantial amounts for payment of security purchases,

which checks had been returned to Merrill Lynch by the drawee bank for insufficient funds.

e. Merrill Lynch had previously limited Michael Dobich from trading with it in commodities in his individual account because of his erratic trading practices.

f. Merrill Lynch did not receive from Dobich Securities Corporation any statement as to its assets, liabilities or net worth.

g. Merrill Lynch did not receive from Dobich Securities Corporation any bank references or make any inquiries in respect thereto.

In addition, Merrill Lynch has admitted for the purposes of the Motion for Summary Judgment that it knew that the funds used in the Dobich Securities Corporation account were customer funds which had been converted by Michael Dobich for such purpose. In addition, Merrill Lynch has admitted that the trading in the Bankrupt's accounts constituted speculation in highly volatile stocks and constituted transactions which could be classified as "block trading" and "day trades."

Based upon these facts, the Trustee prosecuted this action, pursuant to Order of Court, to recover on behalf of the Estate of the Bankrupt the total net transfers of funds and property made to Merrill Lynch in violation of the Federal Securities Laws.

The Court of Appeals unanimously affirmed the District Courts denial of Petitioners Motion for Summary Judgment as to Counts I, II and II.

ARGUMENT

REASONS FOR DENYING THE WRIT WITH RESPECT TO BOTH QUESTIONS

The affirming by the Court below of the District Court's denial of the Petitioner's Motion for Summary Judgment as to Counts I, II and III is a non-final interlocutory order. In its decision, the Court below pointed out that final determination of certain of the questions could not be made until the case is actually tried. In exercising its discretionary power in the certiorari area, this Court has made clear that review of non-final judgments is reserved for certain exceptional cases. *Market Street Railway Co. v. R. R. Commission of California,* 324 U.S. 548 (1945); *Hamilton Shoe Co. v. Wolf Bros.,* 240 U.S. 251 (1916); *American Construction Co. v. Jacksonville Rwy.* 148 U.S. 372 (1893).

This case certainly does not fall within that special area. There is no important jurisdictional question raised since both parties agree that the Federal Court has the authority to hear and determine this case which involves alleged violations of the Federal Securities Laws.

In addition, the Petitioner has chosen not to present to this Court for review any issue as to Counts II and III of Respondents' Complaint. These Counts allege that Petitioner violated, either as a principal or as an aider and abettor, Section 17 of the Securities Act of 1933 (15 U.S.C. § 77q) and Rule 10b-5 of the Securities Exchange Commission. Attacks on these Counts were made by the Motion

for Summary Judgment and were considered by the Court below. Of the two questions presented by Petitioner for review, the second is of broader significance. However, it is not nearly so significant in this case since the second question only presents the issue raised in Count I and does not touch on any issue raised by the Motion for Summary Judgment as to Counts II and III. Thus, even if this Court should grant the Petition and overrule the District Court and the Court below as to the second question, this case would still have to be tried as to Counts II and III. The interlocutory nature of the decision herein was pointed out by the Court below when it stated:

> "Until this case is actually tried, it will be impossible to ascertain whether defendant has violated Rule 405, and if so, whether the violations justify the imposition of liability." 410 F 2d at 143.

This case clearly does not involve such exceptional circumstance to require this Court to review an interlocutory decision.

REASONS FOR DENYING THE WRIT WITH RESPECT TO THE FIRST QUESTION

A. There Is No Important Question of Federal Law.

The first question presented by Petitioners for review is uniquely narrow. It involves:

1. Conversion of customers' property by a stockbroker.

2. The use by the stockbroker of the converted property in its own account with a member firm of the New York Stock Exchange.

3. Knowledge by the member firm of the source of the property.

4. The subsequent bankruptcy of the stockbroker.

5. An action brought by the Trustee of the bankrupt stockbroker against the member firm based upon transfers fraudulent under the Federal Securities Laws.

Obviously the determination of the issues arising from such a unique factual situation could not involve questions of general application to the Federal Bankruptcy Law. The fact that one of the sections of the Bankruptcy Act being interpreted deals specifically with bankruptcies of stockbrokers, serves to further narrow this question. Section 60(e) [11 U.S.C. § 96(e)] was added to the Bankruptcy Act in the 1938 Chandler Act Amendments. Ch. 575, 52 Stat. 840 (1938). A review of the annotations to this section of the Bankruptcy Act reveals that since its enactment fewer than ten cases have been cited as having interpreted Section 60(e). [11 U.S.C.A. § 96; Subdivision 511-515 (1968 and 1969 Supp.)] Clearly the determination of the powers of the trustees of bankrupt stockbrokers is not an area of Federal law which requires this Court's intervention.

B. There Is No Conflict of Decision.

In seeking review on the first question, the Petitioner attempts to set up a conflict in interpretation of the Bankruptcy Act between the decision of the Court of Appeals below and a 1925 decision of the Appellate Division of the New York Court of Appeals. As pointed out by the Court of Appeals herein, the case relied on by Petitioner of *Barnes vs. Schatzkin*, 212 N.Y.S. 536 (1925); aff. 242 N.Y. 552, 152 N.E. 424; cert. den. 273 U.S. 709 (1926), has not been cited by any court since the year 1927 and as a result of the decision in *Tchlenoff vs. Jacobs*, 44 N.Y.S. 2d, 38, 39 (Sup. Ct. 1943), affd. 267 App. Div. 908, 46 N.Y.S. 2d 875, affd.

293 N.Y. 904, 60 N.E. 2d 32 (1944), the decision may no longer represent the view of the New York courts. Furthermore, since Barnes is a decision of a state court, it is not binding upon a Federal Court in its interpretation of a Federal statute such as the Bankruptcy Act. *Comm'r of Internal Revenue v. Est. of Herman J. Bosch,* 387 U.S. 456 (1967); *Howell v. Citizens First National Bank of Ridgewood,* 385 F. 2d 528 (3rd Cir. 1967).

It is impossible to equate the bankruptcy law of 1925 with the law as it exists today. Among the developments which have taken place since the *Barnes* decision in 1925, which make it obvious that under the present law there is no conflict between the *Barnes* decision and the decision below, are the following:

1. The addition of Section 70(c) [11 U.S.C. § 110(c)] under the 1938 Chandler Act Amendments to the Bankruptcy Act [Ch. 575, 52 Stat. 840 (1938)]. This section which is the so-called "strong arm clause" as further amended in 1950 and 1952 provides in part:

> ". . . The trustee, as to all property whether or not coming into possession or control of the court, upon which a creditor of the bankrupt could have obtained a lien by legal or equitable proceedings at the date of bankruptcy, shall be deemed vested as of such date with all the rights, remedies, and powers of a creditor then holding a lien thereon by such proceedings, whether or not such a creditor actually exists."

2. The uses to which the Trustee can put this "strong-arm" power were expanded by the Chandler Act Amendment to Section 70(e) of the Bankruptcy Act [11 U.S.C. § 110(e)]. Although Section 70(e) existed at the time of the *Barnes* decision, it was recast by the Amendment and the Trustee was given the additional power to set aside

transfers which are fraudulent under Federal as well as state law.

3. The passage of the Securities Act of 1933, (15 U.S.C. § 77a et seq.), and the Securities Exchange Act of 1934, (15 U.S.C. § 78a et. seq.). Not only was there no mention of "Federal" law in Section 70(e) at the time of the *Barnes* decision, but there were no Federal Securities Laws in existence to be incorporated into the Bankruptcy Act. It is clear that the activities of the Bankrupt in purchasing securities for its own account with customers' monies is fraudulent under Rule 10(b)(5) of the Securities Exchange Act of 1934. *Securities and Exchange Commission vs. Kelly,* CCH Fed. Sec. L. Rep., Para. 90, 497 (N.D. Ill. 1951) (1948-1952 decisions). Thus, the transfers made to Merrill Lynch in connection with such purchases were fraudulent transfers within the definition of Section 70(e).

4. The addition by the Chandler Act of Section 60(e) of the Bankruptcy Act, [11 U.S.C. § 96(e)] which deals exclusively with bankruptcies involving stockbrokers. Section 60(e)(2) creates a fund for customers of the bankrupt stockbroker including those whose property has been "unlawfully converted by the stockbroker" and Section 60(e)(5) gives the trustee the power to bring actions to set aside transfers which have depleted the fund and provides that "for the purpose of such recovery, the property so transferred shall be deemed to have been the property of the stockbroker."

5. The discrediting of the "pari delicto" theory of Bankruptcy Law. As part of its rationale the *Barnes* court stated: "The bankrupts could not recover against these defendants for bucketing orders because they were responsible for the illegal transactions and parties to the fraud." 212 N.Y.S. at 539.

This so-called "pari-delicto" theory of bankruptcy law has been discredited due to the fact that:

> "When fraud renders a transfer voidable, . . . the trustee ordinarily will be compelled to take affirmative action on the strength of creditors rights under Sec. 70(e) or Sec. 70(c) since the fraudulent transfer will usually be one in which the bankrupt himself participated so that he would be estopped from any action thereon." 4 *Collier on Bankruptcy* (14th Ed.) p. 1534.

In addition the Editors of *Collier's* state:

> "It is to be noted that most of the cases restricting the trustee's right of subrogation to creditors causes of action were decided before the amendments of 1950 and 1952 which have extended the trustee's reach under the strong-arm clause of Sec. 70c." 4 *Collier on Bankruptcy* (14th Ed.) p. 1038.

The leading case in discrediting the *pari-delicto* theory is *Schneider v. O'Neal,* 243 F. 2d 914 (8 Cir. 1957), which was an action by the trustee in bankruptcy of an insurance agency to recover commissions paid by the bankrupt to the defendant, in violation of state law. The defendant was not a licensed agency of the bankrupt and was therefore prohibited by Arkansas insurance law from receiving commissions from the bankrupt. The Court held that under § 70e of the Bankruptcy Act the trustee had a right on behalf of the creditors to recover the commissions paid to the defendant, despite the fact the bankrupt was in *pari-delicto.* As to the contention that the trustee has no greater rights than the bankrupt, the Court stated:

> "While it is unquestionably true that the trustee stood in the shoes of the bankrupt, it is equally true that he stood in the overshoes of the creditors. . . ." 243 F. 2d at 918.

The Court found that § 70e gave the trustee rights and powers on behalf of the *creditors alone,* which were unaffected by the fact the trustee could not have recovered had he stood only in the shoes of the bankrupt.

C. The Decision Below Is Clearly Correct.

The statutory plan as provided in the present Bankruptcy Act, recognizes that Trustees generally, and particularly Trustees of bankruptcy stockbrokers, are in an advantageous position to set aside transfers which defrauded the customers of the bankrupt and to distribute from a "customer's fund" the proceeds recovered pro rata to such customers. This serves, as pointed out by both the District Court and the Court below, to avoid the problems created by possible multiple individual or complex class actions that might result in inequitable distributions of the assets of the bankrupt estate. *Pettit vs. American Stock Exchange,* 217 F. Supp. 21 (S.D. N.Y. 1963). The fact that the statutory plan has worked has been demonstrated in this case where the defrauded customers have regarded the Bankrupt estate and not Merrill Lynch as their debtor and have, therefore, filed their claims with the Bankruptcy Court and have not initiated any private actions against Merrill Lynch. The Respondent's position as supported by the District Court and the Court of Appeals is the only logical interpretation of the Bankruptcy Law as it now exists in keeping with the purpose of efficient Bankruptcy administration. In this regard if the Trustee prevails in this action, the recovery will become a part of the customers fund under § 60(e)(5) and thus will be distributed to those very persons whom the Petitioner claims are the proper Plaintiffs.

REASON FOR DENYING THE WRIT AS TO THE SECOND QUESTION

A. The Decision Below Is In Accord With Decisions Of This Court.

The background of Section 6 of the Securities Exchange Act (15 U.S.C. §78f) and the rule-making power granted to the stock exchanges thereunder was fully examined by this Court in the case of *Silver vs. New York Stock Exchange,* 373 U.S. 341, 83 S. Ct. 1245, 10 L. Ed. 2d 389 (1963). In the *Silver* case an action was brought under the Sherman Act against the Exchange for action taken pursuant to the Rules of the New York Stock Exchange, in arbitrarily denying the plaintiff, an over-the-counter broker who was a non-member of the Exchange, the authority to have a wire connection with members of the Exchange. The District Court had given summary judgment for the plaintiff on the ground that the defendant Exchange had overstepped its authority in attempting to regulate the relations of members with over-the-counter brokers. The Supreme Court held that the Exchange had the right and the duty to make rules in the area of the dealings of members such as Merrill Lynch with non-member brokers such as Dobich Securities Corporation. The Court therein stated:

> "It is no accident that the Exchange's Constitution and rules are permeated with instances of regulation of members' relationships with non-members including non-member broker-dealers. A member's purchase of unlisted securities for itself or on behalf of its customer from a boiler-shop operation creates an obvious danger of loss to the principal in the transaction, and sale of securities to a non-member insufficiently capitalized to protect customers' rights creates similar risks. In addition to the potential financial injury to the investing public and Exchange members that is in-

> herent in these transactions as well as in dealings with non-members who are unreliable for any other reason, all such intercourse carries with it the gravest danger of engendering in the public a loss of confidence in the Exchange and its members, a kind of damage which can significantly impair fulfillment of the Exchange's function in our economy. Rules which regulate Exchange members' doing of business with non-members in the over-the-counter market are therefore very much pertinent to the aims of self-regulation under the 1934 Act. Transactions with non-members under the circumstances mentioned can only be described as 'inconsistent with just and equitable principles of trade,' and rules regulating such dealing are indeed 'just and adequate to insure fair dealing and to protect investors.'' 373 U. S. at 355, 83 S. Ct. at 1255. 10 L. Ed. 2d at 398.

Unfortunately, the very danger which resulted in the caveat expressed by this Court in the *Silver* case is the factual basis for the Respondent's action herein, i.e., the sale of securities by an Exchange member to a non-member firm insufficiently capitalized to protect customers' rights. Thus, by the *Silver* decision this Court has already determined that Rules such as 405 as they are related to the regulation of Exchange members' (such as Merrill Lynch) doing business with non-member firms (such as Dobich Securities Corporation) are within the aims of self-regulation of the 1934 Act. If the importance of the Exchange Rules in the scheme of securities regulation is thus recognized by the Supreme Court it should be clear that a private investor who has been harmed by violation of these Rules could have a cause of action based thereon.

This is in accord with the Court's holding in *J. I. Case Company vs. Borak,* 377 U. S. 426, 84 S. Ct. 1555, 12 L. Ed. 2d 423 (1964) where the issue was a private investor's right to bring an action under § 14(a) of the 1934 act

[15 U.S.C. § 78n(a)] governing the uses of proxy statements. In recognizing the private investor's right, the Court stated.

> "While this language makes no specific reference to a private right of action among its chief purposes is the protection of investors which certainly implies the availability of judicial relief where necessary to achieve the result.
>
> • • •
>
> Private enforcement of the proxy rules provides a necessary supplement to commission action." 377 U.S. at 432.

B. There Is No Conflict of Decision With Other Courts.

Petitioner has attempted to create a conflict with the decision below and that of the Second Circuit in *Colonial Realty Corp. vs. Bache & Co.*, 358 F. 2d 178 (2d Cir. 1966) cert. den. 385 U.S. 817. Colonial's action was based on an alleged oral agreement with the defendant Bache, that Bache would not require a margin in excess of the minimum requirements of the New York Stock Exchange. Colonial sought to recover the losses sustained as a result of all securities sold to meet margin calls which exceeded the minimum requirements of the New York Stock Exchange. Among the counts of the Complaint was a count alleging the violation of Article II, Section (2) of the By-Laws of the New York Stock Exchange requiring members "to observe high standards of commercial honor and just and equitable principles of trade." In this regard it is interesting to note that the plaintiff in the *Colonial* case *did not allege the violation of any specific rule* as has been alleged by the Respondent in the case at bar and in fact the defendant in that case had complied with the New York

Stock Exchange Rule regarding margin requirements. The District Court dismissed the count pertaining to violation of the New York Stock Exchange By-Laws. However, contrary to the reasoning of the District Court, the Court of Appeals specifically recognized that an action could be based upon violation of a *specific rule* of the New York Stock Exchange Rules depending upon "the nature of the particular rule and its place in the regulatory scheme . . ." 385 Fed. at 182. In so holding, the Court stated as follows:

> "Whether such a claim can be maintained for violation of stock exchange rules is a thorny problem because the effect and significance of particular rules may vary with the manner of their adoption and their relationship to provisions and purposes of the statute and SEC regulations thereunder; the difficulty lies in the scope of the unique statutory scheme of 'supervised self-regulation' by exchanges and dealers' associations. See SEC, Report of Special Study of Securities Markets, H. R. Doc. No. 95, 88th Cong. 1st Sess. (1963). *As to matters not covered by the statute or Commission regulations, the exchanges are given a wide range of discretion in establishing standards and principles that should govern trading of securities on the auction market . . .*" 385 F. 2d at 181.
>
> • • •
>
> "On the other hand, we cannot ignore that the concept of supervised self-regulation is broad enough to encompass a rule which provides what amounts to a substitute for regulation by the SEC itself. Not content with insisting upon Commission approval of exchange rules as a prerequisite to registration under §§ 6 and 15A, Congress authorized the agency to request modification of particular rules or to promulgate superseding regulations on its own, § 19. A particular stock exchange rule could thus play an integral part in SEC regulation notwithstanding the Commission's decision to take a back-seat role in its promulgation and enforcement, and *we would not wish to say*

> *that such a rule could not provide the basis for implying a private right of action.''* Citing *Lowenfels, Implied Liabilities Based Upon Stock Exchange Rules,* 66 Columbia L. Rev. 12 (1966.) (Emphasis added.) 358 F. 2d at 182.

Thus, both the Court below and the Second Circuit have agreed that the nature of the rule and its place in the regulatory scheme are the tests to be used in determining whether or not civil liability will be implied from a rule such as Rule 405.

The Court below stated that the touchstone for determining whether or not the violation of a particular rule under particular circumstances is actionable should depend upon its design for the direct protection of investors. Both the District Court and the Court below have stated that their opinions do not mean that alleged violations of Rule 405, or the "Know Your Customer Rule" are actionable *per se.* However, as made clear by the statement by the Supreme Court in the *Silver* case *supra,* Rule 405 as it applies to the relationship between member and non-member firms is clearly for the protection of the investing public because of the danger created by member firms permitting the sale of securities to non-member brokers insufficiently capitalized to protect customer's rights.

There is no conflict between the Second Circuit's decision in the *Colonial* case and the decision below and both cases are logical extensions of the law as stated by this Court in the *Silver* and the *Borak* cases.

CONCLUSION

The decision sought to be reviewed herein is an interlocutory order affirming the overruling of a Motion for Summary Judgment. There is no reason presented by Pe-

titioner herein which should cause this Court to deviate from its well-established procedure of only reviewing final orders.

The first question as to which Petitioner seeks review involves the rights of a Trustee in Bankruptcy of a stockbroker. It is a question of a uniquely narrow character and clearly not a question which requires a determination by this Court. While the second question is of broader significance in the securities law field, it is of limited significance in this case as it applies only to the overruling of Petitioner's Motion as to Count I and does not touch on the issues raised in Counts II and III. The recognition by the decision below of the possible existence of a private right of action for violation of a Rule of the New York Stock Exchange is in accord with the decision of the 2nd Circuit as well as this Court's holdings in the *Silver* and *Borak* cases. The Petitioner's request for a Writ of Certiorrai in this case should be denied.

Respectfully submitted,

HUGH A. THORNBURG
ALAN I. KLINEMAN
JAMES M. KLINEMAN
FRANK M. MCHALE
JOHN I. BRADSHAW, JR.
Attorneys for Respondent.